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Saudi Mortgage Law Could Spark \$32 Billion of Lending a Year

By Zainab Fattah

Oct. 19 After five years of searching for a mortgage in the Saudi Arabian capital, Riyadh, 28-year-old Abdulaziz Al Salem has some advice for his peers: Forget it.

"Home ownership in this country is nothing short of a nightmare," said the father of one. "If you're not descended from a wealthy family or have an extremely successful business, you probably should give the whole thing a pass."

Frustrated young Saudis like Al Salem could spark a lending market that Capitas Group International estimates at \$32 billion a year for the next decade if the kingdom passes a mortgage law that's been a decade in the making. Saudi Arabia is literally millions of homes short of meeting its needs, after housing finance failed to keep up with a population that has quadrupled over 40 years 28.7 million.

The proposed law is part of a planned overhaul of the kingdom's home finance market, regulating all parts of the industry: from registering mortgages to allowing judges to prosecute police officers who refuse to carry out eviction orders. The changes are aimed at easing the concerns of lenders discouraged by unclear regulation that could lead to lengthy court disputes.

"You can't function as a mortgage finance business without having a law that regulates all activities," said Henry Azzam, chairman of Deutsche Bank AG in the Middle East and North Africa. The new law will encourage banks to lend by making it easier to take action when a borrower doesn't pay, he said.

Vote Imminent

A vote by the country's Shura Council on disputed sections of the law is expected within the next few weeks, said Abdulaziz Al Gasim, a partner at Al Gasim Law Firm who was involved with drafting the mortgage law alongside Allen & Overy LLP. If the government and the council can't agree, King Abdullah will have to make the decision himself.

Credit Suisse Group AG estimates that 2 million homes must be built by 2014. Saleh Al-Shoaibi, head of the Shura Council's Economic Affairs and Energy Committee, says the country will need 18 million to 20 million homes over 10 years.

"The demand is huge and can't be easily met," Al-Shoaibi said. "It will require a system that facilitates home ownership."

Saudi authorities began drafting the new property laws about a decade ago. Provisions about evictions and home foreclosures led to disagreements between the government and the Shura Council, delaying its passage for years. The latest hurdle involves the way Islamic products should be regulated and which authorities will be responsible, Al Gasim said.

Islamic Law

Saudi Arabia, the most populous of the Gulf Cooperation Council countries, favors a strict interpretation of Islamic law that's overseen by religious authorities. Lending for the purpose of receiving interest payments is banned, prompting Islamic finance arrangements akin to shared ownership or payment by installments. Sixty percent of the country's 28.7 million people are below the age of 25.

Less than 1 percent of all Saudi home purchases are financed by mortgages. That compares with 7 percent in neighboring United Arab Emirates and 66 percent in the United States, Deutsche Bank estimated in November.

Banks have avoided lending because the Saudi notary public doesn't recognize conventional loans and conflicts with non-paying buyers would lead to battles in an untested legal system, said Glenn Lovell, an associate at law firm Al Tamimi & Co.

Delays in passing the mortgage law haven't damped the enthusiasm of all lenders. Deutsche Bank formed a \$110 million joint venture for mortgages compliant with Islamic sharia law in April and it's already giving out 5-year to 20-year mortgages to both Saudis and foreigners living in the kingdom.

Young Couples

"The segment that we're targeting is the 500,000 riyal (\$133,000) home mortgage," said Paul Loiacono, chief operating officer at Deutsche Gulf Finance. "The person looking for that is part of a young up-and-coming couple looking to buy a first home."

Builders in the Persian Gulf region, hit by slumping orders in their home countries, are eager to expand in Saudi Arabia when lending picks up. Sorooh Investment of Kuwait started its property development unit in the kingdom after the financial crisis hit the region in mid-2008. It's now building two projects in the country's eastern province, gaining a foothold in the market ahead of the law.

"When a mortgage law passes, Saudi Arabia will pull in most of the region's real estate developers and construction companies," said Tariq Ali Al-Binali, Sorooh's vice president of investment. "Every company will be looking to do business in Saudi."



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Strings Attached

Though mortgages are available to young Saudis, they tend to come with strings attached that are unpopular with borrowers. Lenders often demand the title to the property, stress their right to evict defaulters and seek complete control over borrowers' accounts to prevent them from obtaining loans elsewhere.

"I've been renting for the past 10 years and that's money down the drain," said Badr Abdulla, a 29-year-old resident of Riyadh. "But that's still better than putting my life and bank account under the direct control of banks."

Right now, most buyers pay cash or get interest-free loans from the country's Real Estate Development Fund, which can't keep up with the large number of applicants, according to Deutsche Bank. Some use money provided by the fund to buy land before tapping into consumer loans, end-of-service pay or pensions to fund the construction of homes. Others rely on cash gifts from their families combined with personal loans to build or buy homes.

No Collateral

Banks are "simply looking at the pay of an individual, mostly in the high-income segment, because they don't have direct recourse to an asset," said Naveed Siddiqui, chief executive officer of Capitas Group International, a Saudi Arabia-based holding company focused on Islamic financing. "The law will give them that recourse and that's a big, big stimulus."

Most of Saudi Arabia's demand is centered in the low-and mid-income segment with prices of about 500,000 riyals. Most projects under construction are at the upper end of the market, where prices are three times higher, according to Imad Damrah, country director at property consultants Colliers International.

"It's virtually impossible to find a good-quality apartment at a reasonable price," said Al Salem, who is still no closer to making purchase. "Most buildings lack proper facilities and the designs are very old. The finishing in many of the new developments is also not worth the money they are demanding."

Mismatch

The mismatch is unlikely to be resolved without government intervention through public-private partnerships that would subsidize developers, said Al Gasim, who sits on the mortgage law committee.

"The government may have to finance the building of low-to mid-income housing the same way it financed petrochemical projects," he said. "Effectively, it would have to lead both supply and demand."

The Saudi government may extend an experimental program that allows some developers to sell properties before they are built to help secure funding for construction. Previously, companies had to finance projects in full before offering properties for sale, according to Credit Suisse.

It may take a couple of years for a new mortgage law to have a significant impact on the market, analysts say. Banks may remain wary of courts overseen by religious judges, especially in cases involving interest, which is prohibited under Islamic law. Regulations on originating and securitizing loans will also take time to work out.

Lending 'Flat'

"When you look at Saudi banks' loan growth, it has been flat or contracting," said Tarik El Mejjad, a London-based analyst at Nomura International Plc. "Banks have to first deal with issues of loan securitization if they are to broaden their funding sources."

Though there are many hurdles to overcome, passing a mortgage law is a matter of when, not if, Deutsche Gulf Finance's Loiacono said.

"There are huge social pressures that I see every day with my customers," he said. The law "is the only way to free up the real estate market and bring it to the masses. It has to happen."

Al Salem plans to wait a few years before resuming his long search for an affordable mortgage.

"Maybe in five years home prices will have come down and mortgages will be more affordable as more banks get into the market and compete for my business," he said.

--Editors: Ross Larsen, Andrew Blackman.